THE COMMERCIAL PAPER DEBATE

One of the more important objects sought in the establishment of the new federal reserve system was full elasticity of bank credit. To assure its achievement provision was made for a considerable centralization of bank reserves and for an essentially monopolistic system of note issue. With reserves centralized, with the deposits of local banks with the reserve banks equivalent for the local banks to cash reserves in their own vaults, and with note issue in control of the ultimate reserve authority, the variability in the demand for the two possible forms of bank credit seemed to be provided for. The question that remained was: On what terms and under what conditions should a local bank be permitted to draw on its reserve bank, either for the purpose of strengthening its deposit, and hence its reserve, or for that of obtaining circulating notes? Without adequate provision in this direction the whole system of centralized reserves and of monopolistically issued notes would fail of its purpose, because reserves so controlled and notes so issued can be successfully depended upon only when they are freely accessible or available.

In order to make available to the member banks the resources of the reserve banks, Section 13 of the law provides that upon the indorsement of any of its member banks a federal reserve bank may discount notes, drafts, and bills of exchange arising out of actual commercial transactions, and that the Federal Reserve Board is to have the right to determine or define the character of the paper thus eligible for discount "within the meaning of this act." Specific provision is made for notes, drafts, and bills of exchange secured by staple agricultural products or other goods, wares, or merchandise, but paper covering merely investment securities, except bonds and notes of the government of the United States, is expressly denied the rediscount privilege.

Many interesting points of inquiry are suggested in these provisions, but the one of large and immediate significance grows out of the power of the Federal Reserve Board to define the character

of the domestic paper available "within the meaning of the act" to member banks for the purpose of rediscounting at the reserve banks.

First of all it will be observed that the act imposes on the Federal Reserve Board the obligation to see to it that, however the board may ultimately define the character of the paper eligible for discount at the reserve banks, only paper growing out of "actual commercial transactions" be included in the definition. Express exception is, however, made of bills, etc., based on agricultural and other commodities. That is to say, bills of this kind need not grow out of "actual commercial transactions" but need merely be "secured by" the commodities. On the other hand, purely investment paper, whether it grow out of a "commercial transaction" involving the actual exchange of securities or whether it be issued simply to enable the holder to carry the securities, is expressly excluded. In other words, to put it rather baldly, the act itself, while insisting that the paper eligible for rediscount be that which grows out of "actual commercial transactions," accepts purely speculative paper where agricultural or other commodities are concerned, but denies the acceptability of paper that may, in the field of security trading in highest faith, grow out of actual exchange transactions, and which may therefore, in sound theory, be much more acceptable for rediscount purposes than paper based merely on commodity security.

Taking the act as it stands, however, the responsibility put upon the Federal Reserve Board in defining the character of the paper eligible for rediscount is by no means a light one. By way either of preservation or of alteration the definition that is finally decided upon may have a great influence on American business methods.

Last February the Reserve Bank Organization Committee, charged with the duty of getting the new system started, sent out to clearing-houses, chambers of commerce, etc., a letter asking for suggestions concerning this important definition of commercial paper. The letter, signed by M. C. Elliott, the secretary of the committee, points out that it has been frequently insisted "that commercial paper in a purely technical sense should be construed

to mean obligations which represent the purchase price of some commodity sold," but that the customs in the United States are now such as to afford little of this paper. It states further that the present-day practices in the United States make it difficult to identify bona fide commercial paper. Consequently the committee asked for suggestions, not only as to definition, but also as to standard forms of notes, drafts, and bills of exchange, "to the end that there may be established, as far as possible, a uniform practice among all federal reserve and member banks with respect to the creation of the eligible paper provided for in the Federal Reserve Act."

It will be observed that in its letter the committee emphasizes the desirability of a "uniform practice" among all the banks in this matter of commercial paper. The act itself does not require a uniform definition for every district, but it is obvious that there could not be a free flow of funds in an open market without such substantial uniformity. On the other hand, an impediment standing in the way of the achievement of complete uniformity is to be found in possible differences in the laws of the several states,[1] but as the Uniform Negotiable Instruments Law is now the law in 47[2] states and jurisdictions, it is probably a safe conclusion that the legal obstacles to complete uniformity are not insurmountable. Practical difficulties may be more serious.

At the present time the commercial paper situation in the United States is peculiar. "Commercial paper" in the old and strict sense is little used in this country. "Trade paper," as it is now called, arises in less than 3 per cent of the credit transactions in the United States.[3] In some lines of trade, especially where a local wholesaler does a large business with small tradesmen, the wholesaler will extend credit by taking the retailers' notes; but in obtaining credit for himself the wholesaler will not surrender control of the bundle of retailers' notes, preferring instead to give simply his own note on a general understanding with his banker that the personal note rests on, and is fully covered by, the retailers'

[1] See letter of Baltimore Clearing-House to Organization Committee.

[2] *Journal of the American Bankers Association*, April, 1914, p. 679.

[3] *Annalist*, March 9, 1914, p. 293.

notes.[1] The wholesaler hesitates to surrender to the banker the notes that he receives because he fears that his competitors might get some inkling of his trade connections, etc. In general, "trade paper" is used to settle accounts only when the credit terms are still long, that is, four months or more.[2]

What generally passes as "commercial paper" in the United States is single-name paper. As in the case of the wholesaler referred to above, the borrower of bank credit in these days offers for discount simply his own promissory note. Some of this paper, particularly corporation notes, carries indorsements, but these are largely "accommodation" indorsements, which may buttress the security of the paper but which indicate nothing as to its purpose.

The wide use of single-name paper in this country is largely explained by the fact that the prevailing terms of payment in business transactions are net in 30 or 60 days, with a discount for payment in cash within variously from 10 days to one month. The cash discount allowed is usually so large that a purchaser can ill afford not to take advantage of it. Two per cent discount for cash within ten days, for example, with "60 days net" is equivalent to a return of 12 per cent per annum on one's capital. In actual practice the allowance is often even more liberal. Hence where competition is at all keen the business man is practically forced to adopt the system of cash payments, depending upon his bank to advance to him, on his own notes, the necessary funds. Moreover, so broadly has the custom of taking cash discounts spread that a failure to take advantage of them is generally regarded as an indication of weakness, and tends to undermine general confidence in the business man's credit standing. Hence the necessity for maintaining his credit rating, as well as competition, virtually forces the business man into making anticipatory cash payments and thus, more or less as a consequence, into the general practice of discounting his personal paper.[3]

Furthermore, as business operations have grown to a larger and larger scale, especially in the case of large corporate enterprises,

[1] *Annalist*, March 9, 1914, p. 294.

[2] J. J. Klein, *Annalist*, March 23, 1914, p. 361. [3] *Ibid.*

the credit needs of business have in many cases expanded beyond the capacity of the local banks to supply them. The necessity arose, therefore, to go elsewhere for accommodation. This was met in some cases by the opening of bank accounts in other centers, but obvious difficulties and restrictions attend this method of procedure. More elastic possibilities and fewer difficulties grew out of the employment of middlemen to market the paper over the country as a whole on the best available terms. Hence the note-broker is today an important factor in the discount market. As a result of the note-broker's activities there has come to be established an extensive open market for commercial (single-name) paper in this country, and the rates at which such paper is discounted are regularly reported in the daily newspapers.

This development of a commercial-paper market reflects, of course, a considerable development of the demand of the banks for this form of investment.[1] "Country banks" especially have in the last few years heavily increased their purchases in the open market, because the necessity of writing off heavy losses due to the shrinkage of bond values has tended to make them more timid about investing in securities, and because they have also learned by experience that paper purchased through a broker does not have to be renewed, as does most of the purely local paper.[2]

This development has, of course, tended to put an increasingly heavy responsibility on the note-broker and has brought about, at least to some extent, a readjustment of his business methods. At first note-brokers simply solicited paper from merchants and charged a brokerage fee. Latterly, the custom has grown up for the broker to buy up the paper outright.[3] This forces the broker

[1] During 1912 over $1,700,000,000 in notes were sold by reputable brokers, and they represented in these transactions from 2,500 to 3,000 concerns. In one large eastern state over two-thirds of the state banks and trust companies regularly invest a portion of their funds in this class of paper (J. A. Broderick, *Finance*, October 4, 1913, p. 328). On August 9, 1913, according to the report of the Comptroller of the Currency, the national banks held over six billions of dollars of commercial paper, most of which was single-name.

[2] *Financier*, June 22, 1912.

[3] J. G. Cannon, *Financial Age*, October 19, 1908.

"to stand between the maker and the bank," and to the extent that any given piece of paper may be left on his hands, even though he does not indorse the paper that he sells, it compels him to be very circumspect about the paper that he purchases. Moreover, some banks now purchase paper with an option of return within a specified period, making it a point carefully to inquire about the maker of the paper before the option expires. In the last few years banks as well as brokers have established carefully organized credit departments, the purpose of which is, through careful inquiry into the character and standing of sellers of paper, to enable both brokers and bankers to select paper with sounder discrimination.

This characteristically American discount system differs greatly from that which prevails in Europe. Abroad, single-name paper is very little used.[1] The European banker demands more than one signature, not only as a guaranty of security, but also as an assurance of the validity of the transaction out of which the paper offered for discount grew. When the prospective borrower, for some sufficient reason, does not wish to divulge the names of his clients, as would be necessary if he drew bills on them, he may arrange with his bank for an overdraft (known as a cash advance),[2] or by paying a small commission he may get the bank to "accept" a bill drawn directly on it. With a bank's acceptance a bill, even though drawn by the humblest shopkeeper, becomes a prime investment and may be sold openly on the market at the lowest terms that prevail.[3] On the Continent bank acceptances thus open the market widely to all who can arrange for them, while the open market for single-name paper in this country is restricted to large firms of established reputations.

In view of the prevailing practice in Europe it is interesting to inquire why in America there should have been this peculiar development in the discount field. It has been pointed out that before the Civil War trade paper, as it is now called, was pretty generally used, but the exigencies growing out of the war com-

[1] P. M. Warburg, "The Discount System in Europe," in *Report of the National Monetary Commission.*

[2] *Ibid.;* see also William Jacobs, "Bank Acceptances," in *Report of the National Monetary Commission.*

[3] Warburg, *loc. cit.*

pletely changed the situation. The excessive issue of the greenbacks and the uncertain value of credit instruments covering any appreciable period of time led sellers to endeavor to bring business to a cash basis. Credits were shortened to 30 or even to 10 days, and strong emphasis was placed on immediate payment. With cash discounts alluringly liberal, merchants could ill afford to forego them, and cash payments tended to become more and more common. Big houses offered single-name paper to raise the needed funds, and little by little the older system of settling by the promissory note of the debtor was supplanted by the system of selling on open account, with the choice given to the debtor of a liberal discount for cash or the payment of the due amount "net" at the expiration of a relatively short credit period.

The transition was hastened by the development of the practice of selling goods by sample instead of by personal selection from an accumulated stock. Under the old practice the buyer bought under the rule of *caveat emptor*, but when purchasing by sample he had a right to demand that the delivered goods attain the standard of the sample, and there grew up in consequence the doctrine of "implied warranties." These warranties have in some lines been pushed very far,[1] but in any case the buyer would hesitate to pay for goods until he had had a chance to inspect them, and hence he would as a rule demand that they be consigned to him on open account. The seller, however, cannot afford to wait for payment until his accounts become due. Too much of his capital would be tied up. He is forced, therefore, to go to his banker and, on the basis of his accounts receivable, to offer his own note and thus to obtain release of the capital otherwise temporarily beyond reach.

Whatever the determining causes, the fact remains that single-name paper virtually monopolizes the field, and attention may now be directed toward the debate which it has engendered.

The question at issue in this debate is whether single-name paper can safely be made acceptable for rediscount purposes at the federal reserve banks. Two aspects of this question must be distinguished.

[1] E. D. Page, *Annalist*, March 16, 1914, p. 324.

The first concerns the requirements from the point of view of theory as to the essential character of the obligations that are made acceptable "cover" at the reserve banks for circulating notes or for deposit-credit advances that are themselves considered as reserves,[1] while the second involves the practical question as to what the Federal Reserve Act itself demands.

Theoretically no advance of bank credit in any form should be made except to facilitate a socially productive exchange of wealth, the final payment for which is temporarily deferred. Bank credit is a medium of exchange whose existence is made possible by the assumption on the part of the bank of a corresponding liability to pay cash on demand. The nature of this liability precludes the use of bank credit for any but short periods of deferred payments and for any purposes except bona fide exchange transactions. It bridges the gap between the surrender of capital and the receipt of payment for it. Its purpose is to anticipate a credit already established rather than to create one anew. Loans made simply to enable an owner of commodities to hold them for a "rise" do not grow out of exchange transactions. An additional medium of exchange is needed only when there are additional exchanges, and the holding of goods back from exchange reduces and does not add to the number of such exchanges. However profitable speculative and similar loans may be to those immediately concerned, they are not a safe basis for advances by note-issuing or reserve-holding banks.

The practical aspect, as was said, concerns what the law actually requires. As already indicated, the act compromises to a certain degree with the demands of sound theory, but that compromise is not involved in the debate which constitutes the theme of this article, and we may therefore pass it by. Beyond the compromise, however, there can be no question that the demand is for paper growing out of actual exchange transactions, and the power of interpretation given to the Federal Reserve Board applies only to

[1] In this connection more emphasis is often put on the use of the paper as cover for circulating notes than on its use as cover for deposit credits. But as notes under the Federal Reserve Act are not available for reserve purposes, the greater emphasis should be put on the paper as cover for deposits.

the paper coming "within the meaning" of the act. Two-name or trade paper, not simply accommodation paper, necessarily implies the passing of some valuable good for which obligation is acknowledged. Single-name paper, however, carries no such necessary implication. Some of it is true commercial paper, but much of it is not, and the question is whether single-name paper shall be refused altogether by the reserve banks or whether through a satisfactory definition of character a careful selection can be made so that the bona fide single-name commercial paper may command rediscount privileges equal to those extended to double-name paper.

THE CASE AGAINST SINGLE-NAME PAPER

The assaults against single-name paper are based on disapproval of its security as an investment, on the results of its functioning as a credit instrument, and on its general position in the operation of the new banking system.

The charge is made that single-name paper is unsafe as a bank investment. Where brokers are depended upon it is claimed that there is a constant stimulus to firms to offer their paper in the market when the needs of such firms could and should be met by local banks. At maturity this paper is liquidated with the proceeds of other notes and the ease of securing funds in this way leads to long-time and hence unsafe investment of what are properly merely temporary resources.[1] Moreover, oftentimes several brokers are employed by a firm at the same time and there is no effective check on its operations. While the custom of making audits is fairly general, it is charged that the audits are made by friendly accountants at times peculiarly favorable to the borrowers, and that even where this is not the case it is virtually impossible to get an effective check on bills payable.[2] On the other hand, where brokers are not employed, bankers themselves admit that it is the general practice to lend to firms on their single-name paper simply because they carry deposit balances with the banks, despite the fact that at times the paper of such firms would never be

[1] J. A. Broderick, *Finance*, October 4, 1913, p. 329.

[2] *Ibid.*

bought on the open market.[1] Hence, owing to this looseness, the possibilities of loss arising from single-name paper are believed to be numerous and serious.[2]

While it must be admitted that the losses thus far, especially in connection with the paper sold by brokers, have not been large,[3] the contention is made that this has been due to the fact that until a few years ago only firms with the highest credit would borrow in this way. Today the market is broadening and elements of danger have been disclosed.

Involved, perhaps, in the charge that single-name paper is unsafe is the further assertion that it leads directly to overextension of credit to individuals and firms. It is asserted that some concerns borrow from their local banks on warehouse receipts or by giving the guaranty or indorsement of officers or directors, and at the same time sell their own paper in the open market.[4] Textile mills borrow against merchandise consigned to selling agents while

[1] See J. T. Talbert of the National City Bank of New York, *Commerce Monthly*, April, 1909.

[2] Mr. Owen Shepherd, of the International Paper Company, classifies the possibilities of loss arising from the use of single-name paper as follows:

1. Dishonesty on the part of a broker.
   a) In selling foreign paper.
   b) In putting out paper of known bad concerns.
   c) Through collusion with those who desire to issue paper dishonestly.
2. Inability on the part of the broker.
   a) In being misled as to his client's standing.
   b) In engaging his customers to issue more paper than they are justified in doing.
   c) By accepting improperly authorized paper.
3. Dishonesty on the part of the maker of the paper.
   a) Through false statements.
   b) Through flotation of paper not properly recorded.
   c) Through maintenance of separate bookkeeping systems or by other means by which public auditors may be prevented from obtaining full knowledge of the amount of outstanding paper.
4. Inability of the maker.
   a) By undertaking a larger business than his capital warrants.
   b) Through overexpansion due to a desire to speculate in his business by overbuying for a prospective rise or otherwise.
5. General overexpansion in many lines which might lead to panic and financial ruin.
6. Failure due to apparently unavoidable circumstances.

[3] Banks were hard hit, however, by the Westinghouse failure as well as that of the Pillsbury Flour Co. Other examples also could be cited. As this article goes to press it is reported that paper of the embarrassed H. B. Claflin Co., to the amount of over $30,000,000, is held in all parts of the county by some 5,000 banks to which it was sold, through note-brokers, as paper of the highest class.

[4] *Rand-McNally's Bankers' Monthly*, August, 1913, p. 28.

at the same time they assign their accounts receivable to their selling agents and borrow against them.[1] In the piano trade advances are made by banks to firms which have sold pianos on the instalment plan and which use the instalment leases as collateral for their paper. The *Musical Age* reports some cases where these leases were duplicated or even quadruplicated and loans made on all the copies.[2] Some firms also have three or four brokerage connections and sell through all of them. Before there was any extended open market for single-name paper the practice obtained of requiring each firm periodically to pay all its outstanding notes out of the assets of the business. Credits could thus be tested. But now it is said that this wholesome practice has gone by the board.[3] The test now is, not of the debtor's ability to pay, but of his ability further to borrow.[4]

It is also pointed out that the development of "open-account" selling, which underlies the use of single-name paper, has introduced laxity in the settlement of obligations and has lowered the general level of business ethics. Extra large orders are sent in on the assumption that the unsold portions can on one pretext or another be returned. Due-dates are overlooked or are purposely disregarded and the seller is forced to assume the responsibility of collecting the money owing to him. Some of the largest buyers, indeed, like railroads, municipalities, etc., are notoriously the worst offenders in this way. Sellers must then look elsewhere for funds, and prices are of course adjusted to this necessity. Hence it is asserted that not only do the conditions underlying single-name paper lower the general business tone, but also that in a good many directions they result in higher prices than would prevail if settlements were prompt and certain.

[1] *Ibid.*

[2] *Ibid.*, August 9, 1913.

[3] Charles T. Kelsey, *Proceedings of the Minnesota Bankers' Association*, 1911.

[4] In his 1913 report Superintendent Van Tuyl of New York points out that some borrowers borrow large amounts from a number of institutions, each institution making its loan on the assumption that it is the only large creditor. A case was found in which a borrower maintained loan accounts in 29 different institutions. Another individual was discovered borrowing in the name of 30 different individuals and corporations.

Objection is also made that single-name paper would never be purchased by the foreign banker. This objection is serious. One of the purposes of the Federal Reserve Act was to create an open discount market to which foreign as well as domestic bankers would be attracted. If, however, there be only or primarily single-name paper available in such a market, it is contended that the foreigner would not be persuaded to come into it on a scale sufficiently large to guarantee the fulfilment of its purpose.

In contrast with these shortcomings of single-name paper its opponents point to the advantages of two-name or trade paper. They claim not only that two-name paper is safer as an investment for the bank but also that it is better for the merchant from the viewpoint both of security and of economy. Two-name paper or the acceptance gives the seller a formal acknowledgment of the correctness of the amount involved, and at the same time constitutes in his hand a readily available instrument for discounting.[1] With its use, less bookkeeping is necessary and due-dates cannot be overlooked. The greater security that arises under the two-name system permits closer figuring, both in credit and on prices, and, for the same reason, other things equal, two-name paper is bound to command a lower rate of discount than is quoted for single-name paper. All in all, therefore, two-name paper is held to be not only better but cheaper than single-name paper.

Furthermore, the contention is made that only two-name paper will attract the foreigner to the American discount market. Single-name paper fails in this respect because much of it is speculative paper rather than bona fide commercial paper. The purpose of two-name paper, however, is apparent on its face; it would be freely acceptable to the foreign banker and if he could be persuaded to take it instead of gold it would constitute an effective protection against untoward gold exports.[2]

The two-name paper advocates contend also that in the operation of the Federal Reserve Act emphasis on two-name paper would be helpful to the small banks. The argument employed to sub-

[1] William Ingle, *Journal of Commerce*, March 16, 1914.

[2] See J. E. Gardin, *New York Times*, March 1, 1914, and also the letter of the New York Clearing-House Committee to the Organization Committee.

stantiate this contention is that two-name paper grows out of regular business transactions and constitutes the main investment reliance of the small banks. Single-name paper, on the other hand, is put out by the larger business houses who bank with large institutions in the big cities. Hence if single-name paper were admitted without restriction by the reserve banks most of their resources would tend to be absorbed in that class of paper. The small bank and the small business house would thus both be discriminated against.[1]

On the whole, therefore, say the critics of the single-name system, because of the shortcomings of single-name paper and because of the superior qualifications of two-name paper, single-name paper ought to be debarred from the federal reserve system, and the effort should be made to go over to the European system.

THE CASE FOR THE SINGLE-NAME SYSTEM

The advocates of the single-name system not only attempt to refute the charges of the critics of single-name paper, but they also endeavor to force the recognition of certain positive advantages of this paper, and seek finally to establish their case by impugning the character and practical standing of two-name paper.

They claim that single-name paper is just as safe as two-name paper, if not safer. It is asserted that the note-broker of today keeps in touch with his clients, sees to it that their borrowings are not excessive, and that the proceeds are properly used; and follows every detail of their business so that he can give the banks necessary data concerning their standing and business policy. One mercantile bank in New York is reported to have suffered a loss on investments in single-name paper of less than one-half of 1 per cent on business of over two hundred million dollars.[2] Furthermore,

[1] In support of their contention that the transition to a two-name system is not only desirable but thoroughly practicable the advocates of this system point out that many business men favor it and that some firms have already adopted it. In the furniture trade, indeed, settlement by note or by accepted draft has long been the custom. But in other lines where open-account selling has been the rule the two-name system has been successfully introduced. See, for example, *Journal of Commerce*, March 12, 1914, p. 1; *New York Times*, March 16, 1914.

[2] *New York Post*, March 14, 1914.

Mr. J. G. Cannon says that of the collateral held against clearing-house loan certificates during the panic of 1907, the total of which was over four hundred and fifty million dollars, 72.29 per cent consisted of commercial paper, of which only a negligible fraction proved unsound.

It is also contended that single-name paper is more liquid. This claim grows out of the assumption that single-name paper really rests upon numerous "accounts receivable." The argument is that single-name paper is used to make available larger amounts of these accounts which are the result of merchandise sold and delivered and which liquidate themselves automatically. The constant liquidation of the underlying accounts gives the superimposed paper the quality of certain fluidity.[1]

Similarly the contention is made that single-name paper is more economical. Here the argument is that the modern short-term credit methods of trading made possible a great decline in profits and in prices during the last twenty years, but that if extension of credit were to be made on a longer basis the risk involved would be increased and prices would necessarily be higher.

Practical expediency in getting the new system started is also appealed to. It is claimed that the amount of two-name paper at present available is not sufficient to supply the projected reserve banks with adequate investment for their resources. And in answer to the objection that an open discount market would never develop under the single-name system because of the unwillingness of the foreign banker to take single-name paper, the answer is made that if the borrower's note receives the indorsement of his banker, and especially if such note were rediscounted at the federal reserve bank, it would unquestionably be acceptable to the foreign banker. Thus one enthusiastic advocate exclaims: "Should not the forty bill-brokers of the United Kingdom be easier to educate to a thoroughly good article than the seventeen hundred thousand American business men who have sought their welfare, and incidentally that of the people whom they serve, in the customs which they have evolved in the processes of commodity exchange?"

[1] E. D. Page, *Annalist*, March 16, 1914, p. 324.

It is further claimed that discrimination against single-name paper would hurt the small banks. In support of this it is pointed out that more than three-quarters of the unsecured paper held by country banks is single-name; that the retailer or small dealer cannot get notes from customers, while he can give notes to the wholesaler or manufacturer from whom he buys, and therefore that these notes would naturally drift to the commercial and financial centers. Hence, to get them the country banker would have to buy in the open market or take them from his correspondents.

The Baltimore Clearing-House Association in its letter to the Organization Committee declares in this connection that even the bank's own direct obligation or single-name paper should be accepted for rediscount if the small banks are going to benefit by the new system. The letter states that banks in small communities borrow from their correspondents on their direct obligations secured by small and long-time notes, and that they ought to be permitted so to borrow from the reserve banks as well. Otherwise it is feared that no large number of such banks will join the system.[1]

It is insisted by the single-name-paper advocates that the system which they urge and which now prevails is a "natural evolution," growing out of peculiar American methods of doing business. A failure to make such paper eligible for rediscount purposes at the federal reserve banks would, they aver, involve an arbitrary readjustment of habits and usages on a purely artificial basis.

Not content with defending their system, the advocates of single-name paper fire a broadside at two-name paper. The criticisms which they hurl are various. Some of these criticisms reflect on the character of two-name paper. It is held, for example, that the two-name paper now available is not of the best quality because firms of the highest standing will not give notes in settlement of accounts, but prefer by the use of their own credit to get the benefit of cash discounts. It is also averred that two-name paper would make possible an exchange of accommodation paper between two individuals.[2] Finally, one critic contends that two-name paper

[1] *Journal of Commerce*, February 17, 1914, p. 4.

[2] E. Naumberg, *Annalist*, March 23, 1914, p. 369.

may lead to overexpansion.[1] The argument here is interesting. It is that when a buyer of goods borrows on his own name, the bank's interest is solely that of a money-lender. The bank is therefore well informed. But if the seller is paid with notes his main interest is in the profit on the sale, and not knowing the buyer so well as the bank knows him, he (the seller) is bound to extend credit unwisely.

In another class the criticisms deal in general with the inexpediency or impracticability of a return to a two-name system. Thus Chairman Nash of the Corn Exchange Bank of New York and some other bankers hold that any attempt "to engraft on the present system" new systems, however good in other environments, is bound to result in failure. It is also claimed that it would be difficult to get two-name paper in amounts practical for use in banks, and that seasonal borrowers could not well depend upon it.[2]

Numerous examples are also cited tending to show the hopeless impracticability of obtaining notes in various lines of trade. It is said that in the machine trade, for example, if notes were demanded difficulties would arise in cases where machines were returned after trial. In the shoe trade wholesalers deal mostly with small retailers, largely foreigners unfamiliar with banking processes, and such retailers have to be carried on open account. Again, it is alleged that in many businesses where the accounts are small, notes could not be obtained; but even if they were obtainable the additional bookkeeping for the banks would be enormous. Lastly, testimony is adduced to the effect that municipalities and railroads are notorious for their slow payments and that they will not give notes.[3] It is suggested, too, that railroads might even have to receive permission from public service commissions before issuing any notes. Under a system of two-name paper, sellers to cities, counties, railroads, etc., would, it is asserted, be therefore at a disadvantage.

A third class of criticisms against two-name paper concern the

[1] A. E. Adams, *Journal of Commerce,* March 18, 1914.

[2] *Journal of Commerce,* March 12, 1914, p. 1.

[3] *Ibid.*

characteristics of a credit system based on two-name paper. Thus it is maintained that under a system of two-name paper manufacturers and jobbers would have to extend the credit rather than the banks. Banks now lend to the intermediate wholesaler or to the retailer on single-name paper. These dealers then pay cash for the goods they buy, taking advantage of the cash discounts. The manufacturers and jobbers having the money in hand are out of the transaction. If they received notes, however, they would have through their indorsements to carry a contingent liability until the notes matured.[1] Moreover, the big merchants also claim that under a system of two-name paper banks are virtually made preferred creditors. The argument is that a business man's accounts receivable are his most liquid assets. When he discounts his own note the accounts receivable are then relatively large and equally available to all creditors. But if his accounts receivable are for the most part replaced by notes of customers, which notes are then discounted at the bank, the bank gets the ownership of the most liquid assets while the other creditors, who perhaps supplied the very goods the sale of which gave rise to the notes, are left to depend on the remaining, less liquid, general assets.

Lastly, in this class of criticisms of two-name paper may be mentioned the charge that the large and rich dealer will be favored at the expense of the man who is "short of cash but long of character and ability."[2] Professor Sprague of Harvard supports this criticism.[3] The theory is that single-name paper grows purely out of personal credit. The local banker knows his neighbors better than do the big sellers in the distant cities. The banker will therefore lend as necessary to his clients, but the big sellers, while willing to extend credit for short terms, would hesitate to accept a four or a six months' note, even though such paper might be rediscounted at the federal reserve bank.[4]

[1] E. D. Page, *loc. cit.*

[2] *Ibid.*, p. 325.

[3] In "Report of Proceedings of Western Economic Association," *Commercial and Financial Chronicle*, March 21, 1914, p. 883.

[4] E. D. Page, *loc. cit.*

CONCLUSION

What now may be concluded from the arguments as presented by both sides? From the point of view of safety the advocates of two-name paper would seem to have the better case. While fraud is, of course, possible with two-name paper, it seems to be more possible with single-name. The New York Clearing-House was the only large organization that advocated pressure against single-name paper for purposes of rediscount at the reserve banks, yet it is noteworthy that for some years past the subject of better controlling the issue and sale of such paper has been discussed in banking journals, at bankers' conventions, etc. Nobody has more seriously impugned the character of single-name paper than the bankers themselves.[1] The fact that the available two-name paper is not of the best quality finds its explanation in prevailing custom. A change in custom would bring about a change in the character of the paper.

From the viewpoint of elasticity, also, the two-name advocates seem to present the more convincing arguments. The claim that single-name paper is based on a broad foundation of automatically liquidating accounts receivable overlooks the fact that two-name paper is itself an embodiment of a specific account receivable. Similarly, though there is a certain plausibility in the claim that under a system of giving notes the seller will extend credit farther than he would were he carrying the buyer on open account, yet in the last analysis it makes no difference to the solvency of either buyer or seller whether credit is extended on open account or through a promissory note or the acceptance. On the other hand, there is abundant testimony that borrowing on single-name paper is often excessive because of the ease of meeting maturing obligations with the proceeds of new loans.

Two-name paper seems also to be the more economical. The advocate of the single-name system rests his case on the assumption that the adoption of two-name paper would involve a lengthening of the credit term and therefore a consequent increase of risk and of price. The validity of the assumption may be questioned, but even admitting the assumption, there arises the question

[1] See Stuyvesant Fish, for example, in the *Investor*, April 12, 1913.

whether on the average the diffusion of the risk made possible by two-name paper would not more than offset any intensification of that element in the risk which depends merely on the length of the credit term. In the same way with respect to bookkeeping involved, to formal acknowledgment of amounts due, to discount rates, and to ultimate prices charged, the advantage seems to rest on the two-name side.

In connection with the establishment of an open discount market the advantage is clearly on the two-name side. The assertion that it would be easier to educate forty English bill-brokers to appreciate the virtue of single-name paper than it would to change the habits of thousands of American business men has the proper ring. It must be observed, however, that it takes more than a banker's acceptance to make any bill internationally available. European bankers will take only the bills that they are familiar with and even then they discriminate carefully. There are only a few of the larger banks in the European markets whose acceptances provide a ready market for bills.[1] Similarly, just a word or two suffices to close the London market to American finance bills.[2]

Concerning the several points raised under the head of practical expediency, something may be said for both sides. In looking at the effect on the smaller banks, the single-name advocates emphasize the paper directly discounted at the bank while the two-name advocates have in mind the paper sold through brokers. From their respective points of view both are probably right.

The claim made by the Baltimore Clearing-House that much of the paper of the small banks runs longer than ninety days can be met by the statement that if all such paper were six months' paper, at any given time fully one-half would normally mature within ninety days and would, therefore, be available for rediscounting.

There is also the ubiquitous question of the extent to which habits can be changed. No complete change of habits would be necessary in any case. Limiting the rediscount privileges of single-name paper does not necessarily involve a serious limitation of the

[1] Baron von Mellenthin, *Journal of the American Bankers Association*, April, 1914, p. 703.

[2] Hartley Withers, *Money Changing*, p. 125.

privilege of original discount. The limitation would apply only to that proportion of its portfolio which a bank expected to rediscount. The possibility of a transformation of credit methods is largely a question of the inducements that may be offered for it. If these are large enough the change of habits will involve only a question of time. The same may be said in answer to the contention that the reserve banks would not have adequate employment for their funds if single-name paper were excluded.

With respect to the character of a credit system based upon two-name paper, it does not necessarily follow that it would, in view of the present situation, be unnatural and artificial. It has been suggested that the single-name system was a natural outgrowth of our faulty banking system and that a change in the banking system would just as naturally permit the establishment of a new credit system.[1] The charge that under a two-name system manufacturers and merchants rather than banks will lend the credit is also not sound. The bank advances the credit in any case, and the only question is whether the credit shall be advanced directly to the retailer or intermediate wholesaler by one bank or indirectly through the manufacturer or jobber by another bank. It may also be denied that under a two-name system personal credit will be submerged, because, as was pointed out above, the privilege involved is that of rediscount and not that of original discount. Lastly, the complaint that under a two-name system banks will be made virtually preferred creditors is mitigated by the fact that owing to the peculiar nature of their services banks ought to be in a strong position as creditors. In Canada the law specifically recognizes this.[2]

But irrespective of the opposing contentions, the points of importance that the Reserve Board must bear in mind have to do with the security and with the character of the paper made available for rediscount. No question has been raised in either connection concerning two-name paper. To safeguard the original issue of single-name paper, registration, indorsement by the selling

[1] *Journal of Commerce*, March 3, 1914, p. 4.

[2] See J. F. Johnson, "The Canadian Banking System," p. 41, *Report of the National Monetary Commission.*

broker, and insurance have all been suggested. Registration has already been tried. But from the point of view of the Federal Reserve Act, concern about the security of paper purchased need be felt only when the paper is obtained in the open market. Paper offered for rediscount bears a member-bank's indorsement and that is presumably a sufficient guaranty of security. The question that remains, then, involves the purpose to which the proceeds of the paper are applied, because the law permits the acceptance only of paper growing out of commercial transactions and of that based on commodities. If single-name paper is made acceptable, how shall responsibility for the proper use of the funds obtained be enforced?

The New York Clearing-House Association stated in its letter that, while a member bank must necessarily assume a contingent liability for the payment at maturity of paper that it has rediscounted, it would be too much to expect such bank to be responsible also for the use to be made of the funds. It suggested, therefore, two definitions of commercial paper, one referring to two-name and one to single-name paper. These definitions provide for representations on the part of the maker and in some cases on the part of the payee, setting forth the purpose to which the proceeds are to be applied. Penalties would of course have to be provided for false statements.[1]

The Philadelphia Clearing-House in its letter advocated the registration of single-name paper by the federal reserve banks themselves and recommended also that when paper is registered it be accompanied by an affidavit that it is to be used for purposes specified in the Federal Reserve Act. This has been criticised, however, as giving the reserve banks too much power, because the suggestion involves the right on the part of the reserve bank to refuse registration to any firm whenever the bank sees fit.[2]

[1] Anticipating the objection that borrowers mingle their funds, the letter suggests: (1) that the provision for penalties may be directed toward intent at the time of issuance of the paper; (2) the purpose of the law requires that actual commodities be behind the paper, and therefore borrowers should limit their use of paper of this character to the purposes set forth and should make a division of their funds and accounts accordingly, because (3) they can borrow for other legitimate purposes without making the representations required.

[2] Fred Kent, *Wall Street Journal*, March 14, 1914.

The Baltimore Clearing-House, again, advocates the requirement of a certificate setting forth both the intention and the agreement of the drawer of single-name paper to use it for purposes permitted by the law. Such certification could not be included in the body of the instrument, it is believed, because the character of the instrument as negotiable paper might be destroyed thereby.

Other suggestions of similar import have doubtless been made, but enough has been said in this connection to indicate that while there are differences in detail between them, all are based on the notion that some means for establishing the valid character of single-name paper offered for rediscount to federal reserve banks, should the acceptance of that paper be authorized, must be discovered.

But beyond the discovery of a means of testing the character of single-name paper no further action would seem to be essential, and single-name paper might safely be made freely acceptable for rediscount purposes. The New York Clearing-House in its letter advocated that pressure in the shape of a higher discount rate on single- than on double-name paper be brought to bear on the business world to stimulate a change in habits from single-name to double-name. That would hardly seem to be necessary, so far as the Reserve Board is concerned, because the market itself would soon determine to a nicety the relative value of the two kinds of paper, and as time went on the better would drive out the poorer.

An immediate exclusion of single-name paper from the rediscount privilege would, of course, strengthen the demand of the federal reserve as well as of the member banks for two-name paper, and its value would go up accordingly. And just here is probably the crux of the difficulty. Merchants who find single-name paper more convenient and less exacting than two-name may know that inability on the part of the member bank to rediscount single-name paper at the reserve bank does not necessarily involve inability for merchants themselves to discount such paper in the first instance, but they may have to pay a higher rate on the paper not eligible for rediscount, and it is to the higher rate that they object. The interior banker, on the other hand, sees no need for a change. He is constitutionally conservative anyway. The kind of two-

name paper that he is acquainted with offers no especially superior advantage so far as he can see; then why try to force its adoption? The New York banker, largely responsible for the handling of the reserves, has been impressed with the importance of an instrument acceptable to the foreign banker as a means of protecting the reserves. Hence his advocacy of the two-name system. Thus to the several advocates it is largely a matter of individual interest and outlook. Few consider the situation as a whole.

But, it may be asked, suppose that a liberal interpretation were given to the term "commercial transactions," would that necessarily imply an equality of rate for all rediscountable paper? Decidedly not. A permissive definition is not mandatory. The reserve banks may be given permission to rediscount single-name paper with or without guaranties as to the purpose of such paper, but that by no means implies that they will rediscount all such paper offered to them, or that for the sake of the international discount market they will not give a preferential rate to the paper acceptable to the foreigner. Indeed, it may with some confidence be asserted that, however the Reserve Board defines commercial paper, the necessities of the reserve banks in their world-market dealings will compel them to put emphasis on the paper that is internationally acceptable. While, therefore, a change in bank discounts may have a profound influence upon American business habits, it is doubtful whether the whole debate about commercial paper, or any definition that will in the end be made authoritative because of it, will have any controlling influence over the trend of development of these discounts themselves.

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